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SUPREME COURT, U.S.
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Supreme Court of the United States.

OCTOBER TERM, 1930.

No. 31

DAVID A. BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

SANFORD & BROOKS COMPANY.

MOTION OF
CHARLES D. HAMEL, RICHARD S. DOYLE AND BRAINARD AVERY, FOR LEAVE TO FILE BRIEF AS *AMICI CURIAE*

AND

BRIEF AS *AMICI CURIAE*.

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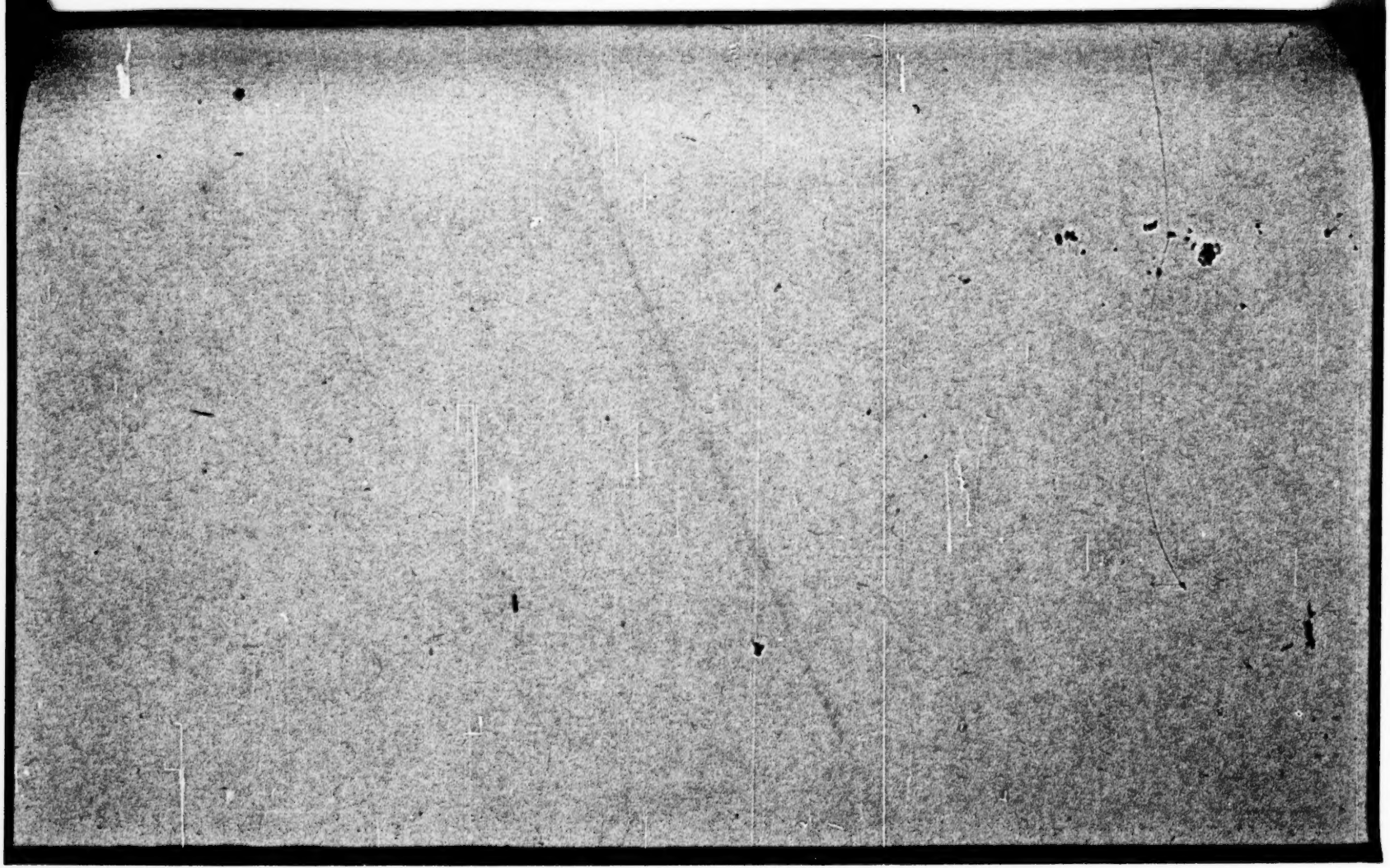

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1930.

No. 31

DAVID A. BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
SANFORD & BROOKS COMPANY.

MOTION FOR LEAVE TO FILE BRIEF AS *Amici Curiae.*

MAY IT PLEASE THE COURT:

The undersigned, as counsel for the firm of Crossman & Sielcken, a partnership in liquidation in the City of New York, State of New York, respectfully move this Honorable Court for leave to file the accompanying brief in this case as *amici curiae.*

CHARLES D. HAMEL,
RICHARD S. DOYLE,
BRAINARD AVERY,
Counsel for Crossman & Sielcken, in Liquidation, as Amici Curiae.

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Should the amount of a judgment in 1920 representing the recovery of losses suffered in 1913, 1914, 1915 and 1916 be included in taxpayer's gross income for the purpose of determining its income tax liability for the year 1920? 2
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SANFORD & BROOKS COMPANY.

BRIEF
OF CHARLES D. HAMEL, RICHARD S. DOYLE, AND BRAINARD AVERY AS *AMICI CURIAE.*

PRELIMINARY STATEMENT.

In 1920 the taxpayer recovered and collected a judgment against the United States for a sum equal to the amount by which expenditures made during the years 1913 to 1916 in performance of a contract exceeded the compensation received under it in those years.

The question in the case is whether the amount of the judgment, which represents recoupment of loss in performance of the contract, constitutes income subject to tax under the Sixteenth Amendment.

Your petitioners are counsel for the firm of Crossman & Sielcken, a partnership in liquidation in New York City, which recovered in 1930, pursuant to a judgment of the District Court for the Southern District of New York, $380,000 capital which was lost in business in 1915. The question at issue in this case is of very great importance, because the decision of this Court may determine whether or not that amount should be included in gross income for 1930 under any of the

provisions of the Revenue Act of 1928 for the purpose of determining net income subject to income tax. It is therefore the desire of counsel to file a brief *amici curiae* on this question.

QUESTION PRESENTED.

Should the amount of a judgment in 1920 representing the recovery of losses suffered in 1913, 1914, 1915 and 1916 be included in taxpayer's gross income for the purpose of determining its income tax liability for the year 1920?

AMENDMENT TO THE CONSTITUTION AND STATUTES INVOLVED.

"AMENDMENT XVI.

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Revenue Act of 1918, c. 18, 40 Stat. 1057:

"SEC. 212. (a) That in the case of an individual the term 'net income' means the gross income as defined in section 213, less the deductions allowed by section 214.

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calender year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *"

"SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such

property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profits, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * * "

"SEC. 233(a) That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in section 213, except that: * * * "

ARGUMENT.

The facts in this case are set forth in the petition for writ of certiorari, but special attention is called to the following statement taken from the findings of fact of the Board of Tax Appeals, 11 B. T. A. 452, 453:

"The petitioner actually expended in the prosecution of the work the sum of $354,009.19. Prior to the recovery under the judgment of the court, petitioner had received from the Government on account of the work in question the sum of $142,959.10, making a difference between the amount expended and the amount received of $211,050.09, the amount recovered in the judgment. The part of this excess of expenditures over payments received, $176,271.88, which was applicable to the petitioner, related to the years 1913 to 1916 on the basis of the excess of expenditures over receipts in these years as follows:

1913	$28,241.03
1914	68,117.81
1915	69,705.15
1916	10,207.89
Total	$176,271.88"

The Board of Tax Appeals found as a fact that the $176,271.88 recovered in 1920 pursuant to the judgment of

the Court of Claims exactly equalled the excess expenditures actually disbursed by the taxpayer over and above the payments received from the Government. The facts in that respect as found by the Board are not questioned in this Court.

The decision of the court below in reversing the Board of Tax Appeals and holding that the amount collected under the judgment in question constituted a reimbursement of a loss sustained and as such was not taxable income is supported by and in harmony with the decisions of this Court in defining what is income within the meaning of the Sixteenth Amendment to the Constitution and the Revenue Statutes.

Section 212(a) of the Revenue Act of 1918 defines net income as gross income less the deductions allowed by the statute.

This Court in its decision in the case of *Eisner* v. *Macomber*, 252 U. S. 189, 207, 208, defined "income" under the Revenue Act of 1916 as follows:

> "After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of August 5, 1909 (Stratton's Independence *v.* Howbert, 231 U. S. 399, 415, 34 Sup. Ct. 136, 140 (58 L. Ed. 285); Doyle *v.* Mitchell Bros. Co., 247 U. S. 179, 185, 38 Sup. Ct. 467, 469 (62 L. Ed. 1054), 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case, 247 U. S. 183, 185. 38 Sup. Ct. 467, 469 (62 L. Ed. 1054).
>
> "Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. '*Derived—from—capital;*' 'the *gain—derived—from—capital,*' etc. Here we have the essential matter: *not* a gain *accruing* to capital; not a *growth*

> or *increment* of value *in* the investment; but a gain, a profit, something of exchangable value, *proceeding from* the property, severed from the capital, however, invested or employed, and *coming in*, being '*derived*'—that is *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property. Nothing else answers the description.
>
> "The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, *from* whatever *source derived*'—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution."

The theory that the words "gross income" are equivalent to "gross receipts" was advanced by the Government in the case of *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 183 and was rejected by this Court, Justice Pitney stating:

> "Starting from this point, the learned Solicitor General has submitted an elaborate argument in behalf of the government, based in part upon theoretical definitions of 'capital,' 'income,' 'profits,' etc., and in part upon expressions quoted from our opinions in Flint *v.* Stone Tracy Co., 220 U. S. 107, 147, 31 Sup. Ct. 342, 55 L. Ed. 389, Ann. Cas. 1912B, 1312, and Anderson *v.* Forty-two Broadway Co., 239 U. S. 69, 72, 36 Sup. Ct. 17, 60 L. Ed. 152, with the object of showing that a conversion of capital into money always produces income, and that for the purposes of the present case, the words 'gross income' are equivalent to 'gross receipts'; the insistence being that the entire proceeds of a conversion of capital assets should be treated as gross income, and that by deducting the mere cost of such assets we arrive at net income. The cases referred to throw little light upon the present matter, and the expressions quoted from the opinions were employed by us with reference to questions wholly remote from any that is here presented.
>
> "The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into

> incongruity with the latter. If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes. There is no express provision that even allows a merchant to deduct the cost of the goods that he sells.
>
> "Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. * * *"

See also *United States* v. *Central Union Bank*, 10 Fed. 612; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *United States* v. *Guggenheim Exploration Co.*, 238 Fed. 231, 237; and *Appeal of James P. McKenna*, 1 B. T. A. 326, 333.

This Court has always recognized the principle that in order to determine whether there has been a gain and the amount of the gain, if any, there must be withdrawn from the gross proceeds an amount sufficient to restore the capital value. See *Doyle* v. *Mitchell Bros. Co.*, *supra*. There is no essential difference in the nature of a transaction, or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction, or one of many. *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 520.

In *Lucas* v. *Alexander*, 279 U. S. 573, 577, 73 L. Ed. 851, this Court, in determining whether or not the proceeds of certain life insurance policies constituted income under the Sixteenth Amendment, distinguished between an amount realized as a profit or gain upon premium investment in a policy, and an amount paid in the nature of an indemnity for, or repayment of, an economic loss suffered by the insured. The decision infers that amounts paid as an indemnity for, or repayment of, an economic loss would not be income to the insured.

Gain or profit is an essential element of income. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, 175. In that case, this Court considered all the facts pertaining to the transaction

extending over a period of years, and concluded that the transaction as a whole resulted in a loss, Justice Butler stating:

> "The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. The essential facts set forth in the complaint are the loans in 1911, 1912, and 1913, the loss in 1913 to 1918 of the moneys borrowed, the excess of such losses over income by more than the item here in controversy, and payment in the equivalent of marks greatly depreciated in value. The result of the whole transaction was a loss."

In the present case, the essential facts are that the taxpayer invested its capital throughout 1913, 1914, 1915 and 1916 in a losing contract; that the excess of such investments over the taxpayer's total contractual receipts was $176,271.88; that the taxpayer was reimbursed in 1920 in an amount exactly equal to the loss thus sustained. The result of the whole transaction was that the taxpayer was simply made whole with respect to a capital outlay. No gain, profit, or income was derived, either economically or within the sense of those terms as repeatedly defined by this Court.

The conclusion of the Court below that the transaction as a whole produced for the taxpayer no gain or profit taxable in any year is sound in fact and sound as a matter of law.

The Government has advanced the argument in the present case that these expenditures in the years 1913 to 1916 aggregating $176,271.88 were taken and allowed as deductions from gross income in the returns of the taxpayer for those years; furthermore that Section 212 prescribes a twelve months period for the determination of income, and that each taxable year stands alone with respect to items of income and deductions according to the events that transpire within that period. In our opinion, the question as to what deductions were taken or allowed in prior years' returns, or what entries were made on the books in those years, is not controlling in this issue. Income is a matter of fact—not of bookkeeping *Appeal of B. B. Todd, Inc.*, 1 B. T. A. 762, 767; *Cleveland Woolen Mills* v.

Commissioner of Internal Revenue, 8 B. T. A. 49. Books are only evidential, being neither indispensable nor conclusive. The decision must rest upon the facts. *Doyle* v. *Mitchell Bros. Co., supra.*

There can be no realization of gain or profit in this transaction until the capital of the taxpayer has been completely restored, even though it requires a period of years and a suit in the Court of Claims to accomplish that result. If the accounting has been deficient in prior years and the statutory period within which to make assessments of additional taxes for those years has expired, we can not see how that would affect the problem as to whether or not the $176,271.88 received in 1920 was income or a reimbursement of capital.

Section 212(b) prescribes that the net income shall be computed upon the basis of an annual accounting period of twelve months, in accordance with the method of accounting employed by the taxpayer. That section also provides that if the method employed does not clearly reflect the net income, then the Commissioner may prescribe a basis which does clearly reflect the income. The Commissioner's own regulations (Article 22 of Regulations 45), in interpretation of that section states:

> "The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income."

There is nothing in that provision of the statute, and nothing in the Commissioner's regulations, which supports the argument that items of income and deductions shall be determined according to the events of any particular taxable year. The express wording of the statute and the Commissioner's own regulations provide for a method of accounting on a basis which clearly reflects income, and if a transaction extends over a period of years, then the income from that transaction shall be reported in the taxable year in which it is realized, that is when the profit is received or accrued. In the present

case, that could not possibly be until the amount of the payments received exceeded the expenditures. In other words, the event that gives rise to taxable income must be one that creates a realization of income.

There are any number of transactions that start in one year and end in another, and the income, if any, is reflected on the books of account in the proper month or year, according to the date of realization. Bookkeeping and accounting methods have been devised and approved by the Government for properly reflecting such income. See Article 36 of Regulations 45, 62, 65 and 69, with reference to reporting income from long-term contracts, and Articles 42, 43, 44 and 45 of Regulations 45, 62, 65 and 69 pertaining to the sale of property on the installment plan. But in no case do we understand that the time or date of realization of income is controlled by the method the taxpayer employs in entering the figures on his books or on his returns. *Appeal of B. B. Todd, Inc., supra.*

The question of what is income has been confused by the Bureau with the deductions allowed by statute for losses. The fact that a capital item recovered was once allowed as a deduction from gross income as a loss does not make that item income. Deductions from income, such as losses, interest, expenses, taxes or other charges, are statutory. They are allowed as deductions from income according to and under the conditions prescribed by the statute, and only in the year in which the loss occurred. *John H. Farish & Co.* v. *Commissioner of Internal Revenue*, 31 Fed. (2d) 79, 7 A. F. T. R. 8540, *Lewellyn* v. *Electric Reduction Company*, 275 U. S. 243.

The Department has permitted, and in many cases required by regulation that taxpayers file with the Collector amended income and profits tax returns correcting errors made in returns for prior years. See Article 36 of Regulations 45, 62, 65 and 69, Article 111 of Regulations 45 and 62, and Article 112 of Regulations 65 and 69. (For other rulings see footnote.)

Amended returns have been permitted or required: Where through wrong accounting practice capital charges have been made to income, *O. D. 113, 1 C. B. 234;* where a corporation issued its bonds at a discount and improperly charged the

The Government in this case has laid great stress on the fact that the taxpayer deducted these expenditures from gross income in its returns for 1913 to 1916. The deduction of a loss on a return in a prior year does not create income by estoppel in a later year when the loss is recovered. That event simply signifies that when the apparent loss was incurred, the best judgment of the parties deemed it irreparable. Actually, subsequent events proved it to be wrong—proved that the loss was reparable. Whatever basis this might afford for retroactively adjusting the situation, in view of subsequent experience (*Inland Products Company* v. *Blair*, 31 Fed. (2d), 867), there is certainly no basis for attempting in the current

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discount to profit and loss, *O. D. 111, 1 C. B. 224;* where errors have been made in valuing inventories, *T. B. M. 31, 1 C. B. 55; T. B. R. 48, 1 C. B. 47; A. R. M. 38, 2 C. B. 54;* where corporations have erroneously taken deductions for donations to the American Red Cross, *Mim. 2207, 1 C. B. 221;* where adjustments have been made to the income of railroad corporations for transactions in prior years, pursuant to instructions of the Interstate Commerce Commission, and such income was erroneously taken up on the books of the corporation during the taxable year, *O. D. 9, 1 C. B. 58;* where the taxpayer has in the past exercised the option of reporting profit on installment sales as at the date of sale and later wishes to change to a basis of reporting the profit on such sales as realized as at the date of collection, amended returns were permitted by ruling, *O. D. 623, 3 C. B. 105; O. D. 567, 3 C. B. 108; Mim. 3170, III-1 C. B. 107;* where returns have been made upon an improper accounting basis, *O. D. 684, 3 C. B. 80;* where a corporation claims additional invested capital because of the excess in value of certain assets over the value at which they were carried on the corporate books, amended returns may be filed for each year for which an erroneous return has been made, both before and subsequent to March 1, 1913, *O. D. 901, 4 C. B. 391;* where taxpayers in preparing returns have used appreciated or inflated values, *T. D. 3243, 5 C. B. 289;* where a guardian has misappropriated funds, the minor may file amended returns showing the loss, *A. R. M. 144, 5 C. B. 139;* where capital expenditures have been erroneously charged to expense, *I. T. 1347, I-1 C. B. 370;* where a stockholder of a corporation was required to pay back a part of the distribu-

year a readjustment under perhaps radically different conditions because of a mistake in deductions in former years. In short, a mistake in judgment as to irreparability of a loss, and an error in claiming deductions, do not create an estoppel and manifestly do not transmute into income what would otherwise not be regarded as income. For instance, let us suppose the cases were as follows: The taxpayer sustained a loss in performing his contract with the United States, but the best legal talent was of the opinion that he had a good claim against the United States for the amount of the loss. The claim is admitted a year or two later by the United States, and delay is made in payment. Under those circumstances the tax-

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tion in liquidation, *I. T. 1164, I-1 C. B. 17;* where annuity payments have been erroneously claimed as deductions from income, *I. T. 1484, I-2 C. B. 66;* where permission is granted the taxpayer to change the method of taking deductions for bad debts under the Revenue Act of 1921, *I. T. 1615, II-1 C. B. 98; I. T. 1774, II-2 C. B. 144;* where separate returns may be filed by husband and wife under the community property laws, *Mim. 3201, III-1 C. B. 346; I. T. 2133, IV-1 C. B. 202;* where certain excise taxes were erroneously accrued and claimed as deductions in prior years, *I. T. 2081, III-2 C. B. 97;* where income has been reported on the long-term contract basis under Art. 36 of Regs. 62, 65, 69 and Art. 334 of Regs. 74, and it is found upon completion of the contract that the net taxable income arising thereunder has not been clearly reflected for any year or years; where taxpayers in computing income from a business have subtracted excessive amounts for redemption of trading stamps, Art. 91 of Regs. 62, 65, 69 and Art. 335 of Reg. 74; where in any case in which it is found that the deductions for depreciation and depletion taken between March 1, 1913, and December 31, 1915, by taxpayers engaged in the oil and gas industry, are not reasonable, Art. 226, Regs. 62, 69; Art. 228, Reg. 65, and Art. 246, Reg. 74; where there is only one legal and proper method of making a return, the taxpayer has erroneously made his return upon some other method, then, even though the return has been accepted and the tax paid, he may file an amended return correcting the error, and if this return shows an overpayment, he is entitled to a refund, decision of the Court of Claims, *Lebolt & Co.* v. *United States,* April 1, 1929, VIII-2 C. B. 247-8.

payer's deduction on his return would be denied and the subsequent recovery would not be included in income. It would be recognized that he was simply reducing a claim for reimbursement to possession. This is not a disposition of the claim giving rise to income.

Are we constrained to reach a different result, if the administrative officials in charge for the United States deny the validity of the claim in the first instance and thus compel a suit?

Whether a deductible loss is sustained may be made to turn on the difference between an admission or denial (*Lucas* v. *American Code Company*, 280 U. S. 445), but certainly whether money received in the current year is a gain derived from capital, labor or both combined, does not depend on the admission or denial in the previous years of the validity of a claim. To so hold would upset fundamental conceptions of the function of juristic institutions even such as this Honorable Court. Judge Learned Hand so aptly pointed out that judgments do not establish rights, they only declare them, *Commissioner of Internal Revenue* v. *Marshall Field*, 42 Fed. (2d) 820, 823:

> "* * * All that happened was that Field and the trustees got into a dispute about the meaning of the will; and Field succeeded in getting the court to take his view. We can not for that reason say that the court's action changed what had all along been his rights; it did not create them; he had them already. We do not of course forget that a disputed right is not for practical purposes an available right at all; or that in fact Field was helpless until the decree passed. Nevertheless, we can not take the judgments of a court as creating property without confusing their function, and substituting juristic metaphysics for those conventions on which in the end most of the law stands. * * * We can not make over fundamental notions in the interest of a more searching theoretic analysis."

The subsequent judgment and payment in this case did not create rights; it declared rights which already existed. The

administrative officers denied them but that did not affect the existence of the rights. When merged in a judgment, when paid for in cash, they were no different than if their validity had been admitted in the first instance. The only difference is that in the first instance, the Government would have insisted that the taxpayer could not claim a loss on his return since for his loss he had a valid claim. Obviously, the Government officials with their eye on consistency could not say that there was a valid claim for income tax purposes and at the same time deny the validity of the claim for the purpose of payment. The errors were obviously errors of the Government officials, but if corrected at this time, it should not be by distorting fundamental concepts of income and a series of mental gymnastics involving a plea of a new kind of "estoppel."

In this connection, we should call attention to *Rice, Barton & Fales, Inc.* v. *Commissioner*, 41 Fed. (2d) 339. That presented a case of gratuitous diminution of a loss suffered in a transaction by the taxpayer. The court held, through Judge Wilson, that the case is similar to this case with the added feature of gratuity, stating that "income is not synonymous with receipts."

If the Court's decision in that case is sound, it creates an apparent dilemma in the present case. If the Government admits retroactively the validity of the claim, having the opinion of a court of claims as a guide, then it follows that there was no deductible loss in the years 1913, 1914, 1915 and 1916, and the items should be corrected in the returns for these years, and consequently there is no basis for contending that the amount is income in 1920 when the valid claim was reduced to possession.

But, if the Government's denial of the claim was deemed proper, then the amount received pursuant to judgment of the Court of Claims is a gratuity or a voluntary moral act by the United States, by virtue of which the capital invested in the transaction was restored to the taxpayer and as such is not income subject to tax, and of course there would be no retroactive adjustment of prior years.

We respectfully submit that the decision of the lower Court is sound, and that this case is controlled by the decision of this Court in *Bowers* v. *Kerbaugh-Empire Company*, *supra*.

CHARLES D. HAMEL,
RICHARD S. DOYLE,
BRAINARD AVERY,
Counsel for Crossman & Sielcken, in Liquidation, as Amici Curiae.